

# ANALYSIS OF ORIGINAL BILL

## Franchise Tax Board

Author: Poochigian Analyst: Darrine Distefano Bill Number: SB 1776  
Related Bills: See Legislative History Telephone: 845-6458 Introduced Date: 02-21-2002  
Attorney: Patrick Kusiak Sponsor: \_\_\_\_\_

**SUBJECT:** Credit for Employee Benefits Paid to Employees Who Are On Active Duty With National Guard or Military Reserve On or After 9/11/2001

### SUMMARY

This bill would:

- allow a 100% credit for wages paid to a qualified employee who is on active duty as a result of Operation Enduring Freedom or any successor military action.
- make changes to the Government Code and Military and Veterans Code regarding employees ordered to active duty as a result of Operation Enduring Freedom. These changes do not affect the department and are not discussed in this analysis.

### PURPOSE OF THE BILL

It appears the intent of this bill is to provide a tax benefit to encourage an employer to pay the difference between their employee's military pay and employee's usual wage. The difference in pay will allow an employee, who earns less with their military pay, to continue to provide the same standard of living for their families while on active duty.

### EFFECTIVE/OPERATIVE DATE

This bill is an urgency measure. It is effective immediately upon enactment and operative for taxable years beginning on or after January 1, 2002. This bill specifies that the credit shall include any benefits paid on or after September 11, 2001, and before January 1, 2002.

### POSITION

Pending.

### ANALYSIS

#### FEDERAL/STATE LAW

Under federal and state laws, compensation received by a member of the armed forces is subject to income tax unless specifically excluded. Compensation received for any month while serving in a combat zone or qualified hazardous duty area is excludable. Other qualified military benefits that are excludable from income include:

Board Position:

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Department Director

Date

Alan Hunter for GHG

04/15/02

- benefits paid by the Veterans Administration, such as disability compensation, pensions, educational assistance, etc.;
- certain medical benefits, military disability benefits, and various travel allowances; and
- dislocation allowances, temporary lodging allowances, and move-in housing allowances provided for a permanent change of station.

Under current state and federal laws, a member of the armed forces of any country and the uniformed services of the United States may exclude from gross income amounts received as a pension, annuity, or similar allowance for personal injury or sickness resulting from active service.

### THIS BILL

This bill would allow an employer a 100% credit for the amount of “benefits” paid to a qualified employee who is called to active duty.

This bill would define “qualified employee” as any member of the California National Guard or United States military reserve organization who is called to active duty on or after September 11, 2001, as a result of Operation Enduring Freedom or any successor military action.

This bill would define “benefits” as the difference between the amount of the employee’s military pay and allowances while on active duty and the amount the employee would have received as an employee of that company, including any raises that would have been granted.

This bill would allow any benefits paid on or after September 11, 2001, and before January 1, 2002, to be treated as if paid during the 2002 calendar year.

Any excess credit could be carried over until exhausted.

### IMPLEMENTATION CONSIDERATIONS

This bill does not limit the number of years the credit may be carried over to future years. The department would be required to retain the carryover on the tax forms indefinitely because unlimited credit carryover is allowed. Recent credits have been enacted with a limitation on the number of years for carryovers since experience shows credits typically are exhausted within eight years of being earned.

The author may wish to further define military pay and allowances. Certain military benefits are excluded from gross income but appear on the employee’s military paycheck. It may be difficult for employers and the department to know what these items are in order to determine how much should be paid to make up the difference. Also, an employer may provide health, dental, retirement, or cafeteria plan payments for their employee. It is not clear if the employer would be entitled to consider these types of payments to calculate the differences in pay. While it appears the bill’s intent is to subsidize the employer’s costs for making up the difference in salary (regardless of what items are taxable), further clarification will be helpful for the employer and the Franchise Tax Board.

## LEGISLATIVE HISTORY

Prior law (Stats. 1943, Ch. 147) allowed a deduction from gross income for all salaries, wages, bonuses, allowances, and other compensation received for service as a member of the Armed Forces for taxable years 1943 through 1948 (World War II). Ch. 12, Stats. 1952, reinstated the World War II exclusion but limited it to \$1,000 per year.

In 1971, another law (Stats. 1971, Ch. 1, Extraordinary Session) further limited the exclusion to compensation (other than pensions and retirement pay) received for service on extended active duty. For taxable years beginning on or after January 1, 1973, Stats. 1972, Ch. 1359, added an annual \$1,000 exclusion from gross income for pensions and retirement pay as well as for compensation for other than extended active duty. However, this exclusion was limited to taxpayers with adjusted gross income of \$17,000 or less.

AB 66 (Stats. 1985, Ch. 1461) increased the phase-out range to \$27,000 for taxable years beginning on or after January 1, 1985. AB 4419 (Stats. 1986, Ch. 779) excluded from gross income up to \$500 per month received for active duty service pursuant to a Governor-declared emergency. AB 53 (Stats. 1987, Ch. 1138) repealed each of these exclusions and established a tax credit, not to exceed \$40 in any taxable year, based on various types of military income. The credit was repealed by its own terms effective January 1, 1992.

AB 1862 (Wyman 2001/2002) is identical to this bill, except that only benefits paid in taxable years beginning on or after January 1, 2002, qualify. This bill is currently referred to both the Assembly Revenue and Taxation Committee and the Veterans Affairs Committee.

## OTHER STATES' INFORMATION

Research of *New York, Illinois, Michigan, Minnesota* and *Massachusetts laws* found that these states do not tax their residents for any military pay received during the taxable year. The laws of these states were reviewed because their tax laws are similar to California's income tax laws.

Since this bill is being introduced due to the events of September 11, 2001, other states also may introduce similar legislation to help taxpayers who are called to active duty. Upon further research of states with a large population of reserve duty military members, *Texas* is recommending that state agencies, colleges, and universities grant their employees a standard monthly emergency leave benefit by providing a salary differential so that their families do not endure a financial hardship if employees are called to active duty.

## FISCAL IMPACT

Once the implementation concerns are resolved, this bill would not significantly impact the department's costs.

## **ECONOMIC IMPACT**

### Revenue Estimate

This bill would result in revenue losses as shown in the following table:

Revenue Impact of SB1776 * For Benefits Paid On Or After 9/11/2001 Assumed Enactment After 6/30/02 Fiscal Year Impact (In Millions)		
2002-3	2003-4	2004-5
-\$70	-\$35	-\$5

\* As discussed below, actual revenue losses could be significantly larger if the projected pattern of reservists call for active duty in the future is exceeded.

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this proposal.

### Revenue Discussion

The impact of this bill would depend upon; (1) the number of employers incurring qualifying expenses for benefits paid to employees who are called up to active military duty and are on active duty during the taxable year and (2) the average credit applied against tax liabilities.

This estimate assumes that the author's intent was that a "qualified employee" be a resident of California.

This estimate is based on the actual number of reservists and National Guard called to active duty to date in California and projections for calendar years 2002 and 2003. This analysis estimates that approximately 6,500 personnel years of reservists and National Guard would be called and used for active duty in 2002. For 2003, it was assumed that one fourth, as many would be called for active duty. For 2004 and thereafter, it was assumed that a minimal number of reservist and National Guard would be called as a result of Operation Enduring Freedom or any successor military action. If additional personnel are called to active duty in 2002 or thereafter, the revenue impact could be much greater.

## **ARGUMENTS/POLICY CONCERNS**

Credits generally are provided as a percentage of amounts paid or incurred. This bill would allow a 100% credit, which is unprecedented.

This bill does not contain a sunset date. Generally, credits contain a sunset date that ensures the Legislature will review its effectiveness.

Conflicting tax policies come into play whenever a credit is provided for an item that is already deductible as a business expense. A taxpayer who is engaged in a trade or business can deduct salaries and wages paid to an employee as an ordinary and necessary business expense. Providing both a credit and allowing the full amount to be deducted would have the effect of providing a double benefit for that item. On the other hand, making an adjustment to deny the deduction in order to eliminate the double benefit creates a difference between state and federal taxable income, which is contrary to the state's general federal conformity policy.

Many employees have been called to active duty to assist with clean up at the sites of the terrorist attacks and to provide security at the airports or other high security risks sites. These employees were called to duty for Homeland Security and not "Operation Enduring Freedom." This bill will not benefit an employer who made payments to employees called to active duty for these assignments.

This bill would not benefit self-employed taxpayers who are also called to active duty. A taxpayer who is self-employed will not be able to take a credit on the benefits paid as defined in the bill. Thus, this bill would provide differing treatment based solely on business entity classification.

This credit would not be limited to benefits paid to employees that are employed in California. As a result, the bill would allow a 100% credit for benefits paid by an employer to an employee performing services anywhere. The author may wish to limit the credit to benefits paid to employees employed in CA.

#### **LEGISLATIVE STAFF CONTACT**

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